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DEPARTMENT OF ENERGY
OFFICE OF HEARINGS AND APPEALS

Interlocutory Order

Name of Case: Chevron USA Inc.

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Chevron USA Inc. (Chevron) filed an appeal with this Office – the Office of Hearings and Appeals (OHA) of the Department of Energy (DOE). The appeal concerns a 2007 Assistant Secretary for Fossil Energy (the ASFE) determination of equity interests in the Elk Hills oil field, also referred to as Naval Petroleum Reserve No. 1 (the Reserve). DOE filed a Motion to Dismiss, in which it requested dismissal of certain issues; during the briefing process, DOE withdrew its objection to some issues. As set forth below, we have determined that DOE's Motion, as amended, should be granted.

I. Background

A detailed history of the Reserve is set forth in *United States v. Standard Oil of Cal.*, 545 F.2d 624 (9th Cir. 1976). Discussions are are also set forth in our decisions in *Chevron USA, Inc.*, 29 DOE ¶ 80,203 (2005) and *Chevron USA Production Co.*, 28 DOE ¶ 80,101 (2000). For purposes of this decision, a brief discussion will suffice.

Congress established the Reserve in 1912 to conserve oil for the national defense. The Reserve was comprised of parcels of land – some owned by the federal government and others owned by Standard Oil of California (Standard), now Chevron USA Inc. Initially, the Department of the Navy (Navy) had jurisdiction over the federal government's interest in the Reserve. In 1977, Congress transferred that jurisdiction to the newly-established DOE.

In 1942, Standard and Navy (also referred to as "the parties") entered into a unit plan contract for limited production of the Reserve. In 1944, after concerns were raised about the legality of the contract, the parties terminated it. That same year, the parties entered into a congressionally-approved Unitized Plan Contract (the UPC) covering a portion of the Reserve (the Unit). Under the UPC, the parties' "participating percentages" in

production, also referred to as "equity interests," were based on estimates of the volume of hydrocarbons underlying their respective lands. The UPC established initial percentages and provided for subsequent redeterminations, retroactive to 1942, as the parties learned about the geological structure of the field.

In 1995, Congress enacted legislation directing that the government sell its interest in the Reserve. National Defense Authorization Act for Fiscal Year 1996, §§ 3412-16, 10 U.S.C. §7420 note. In conjunction with the sale, the parties agreed to a process to determine their final equity interests. The parties' agreement is entitled "Agreement Regarding Equity Redetermination Process" and is also referred to as the "Equity Process Agreement." DOE Mot., Ex. 1.

Under the Equity Process Agreement, the ASFE makes final equity determinations on a zone-by-zone basis. The parties make presentations to an Independent Petroleum Engineer (IPE), who then makes a preliminary recommendation. After the parties comment on the preliminary recommendation, the IPE makes a final recommendation. If the ASFE accepts the IPE recommendation, the matter is final and not appealable. If the ASFE rejects the IPE recommendation on a given issue, Chevron may appeal that issue to OHA. Similarly, if an Independent Legal Advisor (ILA) and the ASFE reject Chevron's position on a legal issue, Chevron may appeal that issue to OHA.

In 2002, the Principal Deputy ASFE (the PDASFE or, for simplicity, the ASFE) issued a decision on the Stevens Zone - the Unit's largest producing zone. DOE Mot., Ex. 3. Chevron appealed, challenging the ASFE's "conversion" methodology, *i.e.*, the methodology for converting the parties' respective volumes of gas into barrel-of-oil equivalents (BOEs), the measure of the "hydrocarbons" underlying the parties' respective lands. The ASFE averaged two conversion factors: one based on relative 1996-1998 prices ("current prices") and one based on relative thermal value.

In 2003, Chevron appealed the 2002 ASFE decision to OHA. In its appeal, Chevron challenged both conversion factors used by the ASFE, arguing that the ASFE should have used a conversion factor based on 1942 prices.

In 2005, we granted the appeal in part. *Chevron*, 29 DOE ¶ 80,203. We noted that, under the UPC, a party's share in a given producing zone was equal to the volume of hydrocarbons in that zone underlying the party's property on November 20, 1942, divided by the total volume underlying the Unit on that date. *Id.* at 80,689. We also noted that the UPC required that each party receive, over the life of the Unit, its volume of hydrocarbons. As the decision indicates, the only conversion methodology that gives that result

is based on prices over the life of the Unit. *Id.* Accordingly, we remanded the matter to the ASFE for a revised determination.

To assist in the order's implementation, we required the ASFE to prepare a schedule showing a calculation of a conversion factor. We stated:

> As part of the remand, the PDASFE should prepare a schedule with the following information:
>
> (a) the Unit's revenues in each month;
> (b) the Unit's revenues in each month as a percentage of total revenues,
> (c) the per barrel price of oil in each month,
> (d) the per thousand cubic feet price of gas in each month,
> (e) the ratio of the price of gas to oil in each month,
> (f) the result of multiplying (b) times (e), and
> (g) the sum of the entries in column (f).
>
> Item (g) is the conversion factor based on the weight-averaged monthly relative price of oil and gas. If the PDASFE determines that for technical reasons Item (g) is not the most accurate weight-averaged conversion factor, the PDASFE should explain why.

C*hevron,* 29 DOE at 80,692. We further stated that Chevron could appeal the resulting determination to this Office. *Id.*

In 2006, the ASFE issued a preliminary decision. DOE Mot., Ex. 12. Chevron challenged several aspects of the preliminary decision. With respect to the formula, Chevron argued that, to be consistent with industry practice, Item (e) of the schedule should be expressed as the ratio of oil over gas, rather than the reverse. DOE Mot., Ex. 13 at 4. In 2007, the ASFE issued a final decision, adopting Chevron's proposal concerning Item (e). *Id.* at 4-5.

After the issuance of the ASFE final decision, Chevron noticed the instant appeal, identifying seven issues. Some of those issues concern Chevron's allegation that DOE breached the Equity Process Agreement, an allegation that Chevron is pursuing in a concurrent federal court proceeding. *See Chevron v. United States,* No. 04-1365C (Ct. Cl. filed Aug. 20, 2004). In conjunction with its notice of appeal, Chevron sought a continuance of the appeal, stating that it needed discovery in the federal court proceeding in order to brief its appeal before OHA. DOE opposed a continuance on

the ground that Chevron's allegation of breach of contract was beyond the scope of the instant appeal.

In late 2007, we denied Chevron's request for a continuance. *Chevron USA Inc.*, 29 DOE ¶ 82,503 (2007). We stated that Chevron's allegation of breach of contract was outside our purview. *Id.* at 84,005. We noted the parties' disagreement over the scope of the appeal, and we stated that the parties should address that disagreement in their briefs. *Id.* Finally, we instructed the parties to file a proposed briefing schedule.

In early 2008, each party filed a "preferred" briefing schedule. Chevron proposed a standard briefing schedule; DOE proposed an initial round of briefing limited to jurisdictional issues. After considering the matter, we provided for an initial round of briefing on jurisdictional issues. *See* Letter from Janet N. Freimuth (OHA) to Donald B. Ayer (counsel for Chevron) and Ada L. Mitrani (counsel for DOE) (January 29, 2008) at 2.

The initial round of briefing began when DOE filed a "Motion to Dismiss Issues Outside OHA's Jurisdiction." In that Motion, DOE did not seek dismissal of two issues identified in Chevron's appeal notice, *i.e.*, Issues 2 and 3. DOE did, however, seek dismissal of the five other issues, *i.e.*, Issue 1 and Issues 4 through 7. Chevron filed a Response, and DOE filed a Reply that limited its Motion in certain respects. Chevron filed a Sur-Reply, and DOE filed a Response to the Sur-Reply.

II. Applicable Standard

The parties agree that the Equity Process Agreement governs this proceeding. They further agree that Paragraph B.8 of the agreement governs the permissible scope of the appeal. They differ, however, on the proper interpretation of Paragraph B.8. We discuss below Paragraph B.8 in the context of the specific issues raised herein.

III. Analysis

A. Issue 1

In its Notice of Appeal, Chevron identified Issue 1 as follows:

> Whether there are technical reasons that the conversion factor established by the formula in OHA's 2005 decision is not the most accurate weight-averaged conversion factor.

Notice of Appeal at 3. In its Response, Chevron redefined Issue 1, stating that OHA's formula was accurate and that the ASFE departed from the formula in two respects: first, by excluding 400 months

involving $2.5 billion in revenues; second, by using, for Item (d) of the formula, a "composite gas value" that included all natural gas liquids (NGLs). Chevron Response at 17. In its Reply, DOE withdrew its jurisdictional objection to having Issue 1 considered on appeal by OHA, as redefined.

In its Response, Chevron also made an alternative argument. Chevron argued that, if the ASFE's exclusion of certain months and use of a composite gas value did not depart from OHA's formula, then OHA's formula did not accurately implement the rationale of OHA's decision. *Id.* at 19. It is not clear to us from the pleadings whether DOE withdrew its Motion with respect to this argument and, therefore, we address it below.

Chevron is free to make the alternative argument noted above. In the 2005 OHA decision, we recognized that there may be technical reasons why the decision's formula may not produce the most accurate weight-averaged conversion factor. If Chevron does argue that there is a more accurate formula, Chevron should include a discussion of the alternative formula proposed by the DOE in proceedings before the ASFE.

B. Issue 4

In its Notice of Appeal, Chevron identified Issue 4 as follows:

> Whether the Unit Plan Contract allows subsurface gas as of November 20, 1942 to be converted to BOEs as if all natural gas liquids ("NGLs") produced from the field originated in that gas when, in fact, produced NGLs originated largely in subsurface oil.

Notice of Appeal at 3. In its request for relief, Chevron asked that NGLs be excluded from the conversion formula altogether or, in the alternative, that NGLs be attributed to subsurface oil, rather than gas. *Id.* at 5.

In its Motion to Dismiss, DOE argued that the inclusion of NGLs was a settled matter and unrelated to the conversion methodology. Chevron responded that the 2007 ASFE decision, for the first time, included "cycled" NGLs, *i.e.*, NGLs produced from re-injected gas, and that re-injected gas contains hydrocarbons absorbed from subsurface oil. Chevron Response at 23. In its Reply, DOE agreed that "cycled" NGLs had not previously been included in the conversion formula, and DOE withdrew its jurisdictional objection with respect to those NGLs. Accordingly, we now turn to DOE's jurisdictional objection to the issue of the ASFE's inclusion of "non-cycled" NGLs.

It is undisputed that the inclusion of NGLs was addressed in the proceedings leading to the 2002 ASFE decision. The IPE recommendation included non-cycled NGLs in the conversion formula, and the ASFE accepted the IPE recommendation. *See* DOE Mot., Ex. 12 at 6.

Under the Equity Process Agreement, the ASFE's acceptance of an IPE recommendation on an issue is final and non-appealable. Paragraph B.7 provides in relevant part:

> If an ASFE decision adopts the [IPE] recommendation for a particular zone, that ASFE decision shall be final and not subject to challenge by Chevron. If an ASFE final decision rejects, in whole or in part, [the IPE's] participation percentage recommendations, Chevron may challenge the ASFE decision and such challenge shall be referred to [OHA] for a decision. In this event, OHA shall review only the points on which the ASFE rejected [the IPE's] recommendations that have been challenged by Chevron, and in all other respects the ASFE's decision shall be final.

DOE Mot., Ex. 1 at 4. Nonetheless, Chevron argues, it can now challenge the inclusion of non-cycled NGLs.

1. Chevron's argument that the 2005 OHA decision "wiped out" the 2002 ASFE decision

Chevron argues that the 2005 OHA decision "wiped out" the 2002 ASFE decision, allowing Chevron to raise previously settled issues, including the inclusion of NGLs in the conversion formula. *See, e.g.,* Chevron Sur-Reply at 4. We disagree.

Chevron's argument is inconsistent with the plain language of Paragraph B.8 of the Equity Process Agreement, which provides in full:

> If OHA denies the Chevron challenge to the ASFE's decision on an issue, the ASFE's decision on such issue shall be final and binding on the parties. If OHA upholds the Chevron challenge on an issue, then the [IPE] recommendations at issue shall be adopted as final. If OHA determines to uphold the ASFE in part, then OHA, in its discretion, may either (i) direct that the [IPE] recommendation on the issue be adopted by the ASFE, (*ii) remand the specific issue back to the ASFE for further determinations in accordance with OHA's instructions,* or (iii) render a decision on such issue based on the record before it. If OHA *remands an issue* to the ASFE, Chevron shall have the right to challenge

> any *further* determination of the ASFE *on such remand* under the process set forth in paragraph B.7 above.

DOE Mot., Ex. 1 at 5 (emphasis added). As the quotation indicates, Chevron's appeal right concerns OHA's remand of a "specific issue" for "further determinations in accordance with OHA's instructions," and the ASFE's "further" determination "on such remand." The fact that the appeal is "under the process set forth in paragraph B.7" does not enlarge the scope of the appeal. Accordingly, the plain language of Paragraph B.8 limits any further appeal to the ASFE's implementation of OHA's instructions.

Efficiency, finality, and common sense support this result. Under Chevron's theory, if, in the future, we order a second remand, our second remand decision would "wipe out" the 2007 ASFE decision and allow Chevron to challenge any aspect of any future ASFE equity determination, including previously settled issues. To adopt such an approach would likely result in endless litigation.

2. Chevron's alternative arguments

Chevron argues that, even if the 2005 OHA decision did not "wipe out" the 2002 ASFE decision, Chevron is still entitled to challenge the inclusion of NGLs. In support, Chevron advances three arguments.

First, Chevron argues, the earlier IPE recommendation to include NGLs was made in the context of the "current price" formula, as opposed to the "contemporaneous price" formula required by OHA's 2005 decision. In our January 29, 2008, letter setting the briefing schedule, we stated that any argument based on differences in the conversion formulas should be specific:

> If Chevron argues that it would have raised an issue before had it known of the applicability of the 2005 remand conversion formula, Chevron should provide a specific and detailed explanation of that argument, including an explanation of relevant differences between the remand formula and the formula under consideration during the prior equity finalization process.

Letter from Janet N. Freimuth, OHA, to Donald B. Ayer (counsel for Chevron) and Ada L. Mitrani (counsel for the ASFE) (January 29, 2008) at 2. Despite that admonition, Chevron has not explained why, if the 2002 ASFE decision had used a conversion factor based on prices over the life of the Unit, Chevron would have appealed the inclusion of NGLs.

Second, Chevron argues that OHA's 2005 decision excludes NGLs from the conversion formula. We disagree. The OHA 2005 decision

addressed the issue of which prices – 1942, current, or contemporaneous over the life of the Unit – should be used to convert gas volumes to BOEs. The issue of what hydrocarbons were included in gas volumes was not presented to OHA in that appeal. Thus, the 2005 OHA decision did not alter prior determinations on the inclusion of NGLs in gas volumes.

Finally, Chevron argues that the ASFE departed from the IPE's methodology for including non-cycled NGLs. Chevron identified those arguments under Issue 1, *supra*, and they will be considered in this proceeding.

C. Issues 5, 6, and 7

In its Notice of Appeal, Chevron identified Issues 5, 6, and 7 as follows:

> 5. Whether the IPE's calculation of equity participation percentages based on "abandonment pressures" of 500 psi in the 26R and NWS A-1 to A-3 reservoirs, later reversed by the ASFE, was arbitrary and capricious or inconsistent with sound oilfield engineering principles.
>
> 6. Whether equity participation percentages should be established without regard to publicly available data that is obtained by the IPE and that affects the IPE's estimates of one party's share of recoverable oil by approximately eight million barrels.
>
> 7. Whether, in establishing equity participation percentages, the results of a simulation model which has not been found to be biased in any way may be diluted by using an average recovery based upon the combination of parcels owned by each party, where the simulation model and other independent methodologies are capable of resolving migration calculations directly and solely for each parcel as required by the five-step process directed by the Settlement Agreement of January 6, 1997 . . . .

Notice of Appeal at 4. Chevron recognizes that its "prior appeal did not address those aspects of the 2002 decision," but argues that it can raise them now. *Id.* at 2. In its Motion to Dismiss, DOE argues that Chevron's failure to raise those issues in its prior appeal rendered them final and not subject to further appeal. Chevron disagrees.

As discussed above, Chevron argues that the 2005 OHA decision "wiped out" the 2002 ASFE decision and, therefore, any finality

associated therewith. *See, e.g.,* Chevron Sur-Reply at 4. As indicated in Part III.B. above, we have rejected that argument.

Chevron also argues that it would have raised Issues 5, 6, and 7 if it had seen a December 2000 IPE report to the ASFE, *see* Chevron Resp., Ex. 13. Chevron argues that the December 2000 report was, in effect, an "IPE recommendation." As the parties recognize, this argument is part of Chevron's federal district court claim that DOE breached the Equity Process Agreement. As we have stated before, Chevron's allegations of breach of contract are outside our purview. *See, e.g., Chevron,* 29 DOE ¶ 82,503. Accordingly, these issues are beyond the scope of the appeal.

IV. Conclusion

In its Motion to Dismiss, DOE did not object to Issues 2 and 3 being heard on appeal, but moved to dismiss Issue 1 and Issues 4 through 7. As the result of the briefing process, DOE excluded, from its Motion, Issue 1 and the portion of Issue 4 related to "cycled NGLs." Accordingly, these issues will be considered by OHA in the context of this appeal. Regarding the remaining issues raised by Chevron *i.e.,* (i) the portion of Issue 4 challenging the inclusion of non-cycled NGLs in the gas component of the conversion formula, and (ii) Issues 5 through 7, we hold that they are outside of the scope of the appeal. Accordingly, we have determined that DOE's motion to dismiss these issues should be granted.

IT IS THEREFORE ORDERED THAT:

(1) The Motion to Dismiss filed by the Department of Energy on February 11, 2008, be, and hereby is, granted as set forth in Paragraph 2 below.

(2) The following issues identified in the Notice of Appeal filed by Chevron USA Inc., on August 24, 2007, are dismissed: (i) the portion of Issue 4 challenging the inclusion of non-cycled NGLs in the gas component of the conversion formula, and (ii) Issues 5 through 7.

Poli A. Marmolejos
Director
Office of Hearings and Appeals

Date: July 15, 2008